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No. 00-590, 00-511, 00-555, 00-587, 00-602

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IN THE

Supreme Court of the United States

AT&T CORP.,

Petitioner,

v.

IOWA UTILITIES BOARD, *et al.*,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF PETITIONER AT&T CORP.

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QUESTIONS PRESENTED

1. Whether the court of appeals erred in holding that 47 U.S.C. § 252(d)(1) forecloses the cost methodology adopted by the FCC, which is based on the efficient replacement cost of existing technology, for determining the interconnection rates that new entrants into local telecommunications markets must pay incumbent local telephone companies?

2. Whether the court of appeals erred in holding that 47 U.S.C. § 251(c)(3) prohibits regulators from requiring that incumbent local telephone companies combine certain previously uncombined network elements when a new entrant requests the combination and agrees to compensate the incumbent for performing that task?

LIST OF PARTIES AND AFFILIATES

The parties to the proceedings in the Eighth Circuit are listed in Appendix A and Appendix D of AT&T's Petition for Certiorari at 1a and 222a-224a.

Pursuant to Supreme Court Rule 29.6, petitioner states as follows: AT&T provides telecommunications, cable, and other services. AT&T has no parent company. No publicly held company owns more than 10 percent of AT&T's stock.

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OPINION BELOW

The opinion of the Eighth Circuit is reported at 219 F.3d 744 and is reprinted at 1a-38a of the Appendix of AT&T's Petition for Certiorari ("Pet. App."). The Order of the Federal Communications Commission ("FCC") is reported at 11 FCC Rcd. 15,499 and is reprinted, in relevant part, at 264-452 of the Joint Appendix ("JA").

JURISDICTION

The judgment of the Court of Appeals was entered on July 18, 2000. AT&T's petition for certiorari was filed on October 13, 2000, and granted on January 22, 2001. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS

The relevant provisions of 47 U.S.C. §§ 153 and 251-252 are reprinted at JA 9 and 11-28.

STATEMENT OF THE CASE

In the 1996 amendments to the Communications Act, Congress sought to promote the rapid introduction of competition in local telephone markets that had long been intractable monopolies. Congress recognized that competitive local carriers could potentially supply some or all of the elements of local telephone service required to reach different classes of customers and that the authorization of local competition could institute a process that would drive retail prices closer to competitive levels.

At the same time, Congress understood that competitive local services cannot and will not develop unless new entrants have the rights economically to access and use those other components of local telephone service that have natural monopoly characteristics and that are controlled by the

incumbent local exchange carriers ("LECs"). Congress thus granted new entrants the rights to "interconnect" with the networks of the incumbent LECs and to "access" designated "elements" of their networks on rates and terms that are "just, reasonable, and nondiscriminatory" and "based on the cost . . . of providing the interconnection or network element." As this Court has held, the Act gives the FCC broad discretion to implement these ambiguous terms in ways that will foster competition. *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. 366, 397 (1999).

But following this Court's reversal of its earlier decision, the Eighth Circuit has again invalidated two of the FCC's 1996 regulations in the decision under review. Each regulation was based on the prior experience of the FCC and other tribunals in introducing competition in long distance services, telephone sets, and other former monopoly telecommunications markets.

First, to implement the requirement that interconnection and network element rates be "based on the cost . . . of providing" them, the FCC adopted a forward-looking long run incremental cost method that is called "TELRIC." It provides for full recovery of all of the LECs' costs (fixed and variable) of providing the required facilities by determining the cost of replacing them with the most efficient generally available equipment. This is the same cost of service standard that economists, antitrust courts, state and federal regulatory bodies, and others have long used to determine the "real" and "economic" cost of providing goods or services. It is the standard that incumbent LECs had also themselves successfully advocated and used in indistinguishable contexts both before and after the 1996 Act was passed.

However, while the Eighth Circuit held that the Act authorizes the use of a forward-looking incremental cost standard, the court invalidated the FCC's TELRIC regulation. It concluded that by requiring that rates be based on the cost of providing "*the*" interconnection or network element,

Congress unambiguously barred the use of an efficient replacement cost method. As explained below, the Eighth Circuit's holding has no basis in the statute's terms, structure, and purposes.

Second, the FCC adopted a regulation that requires incumbent LECs to provide new combinations of network elements in circumstances in which it would be discriminatory, unreasonable, and wasteful to require new entrants to do the combining. The Eighth Circuit invalidated this regulation on the ground that the "plain meaning" of the Act is that LECs cannot be required to combine elements in these or any other conditions. But this Court rejected this very claim in *Iowa Utilities Board*.

To place the issues raised by these rulings in context requires a description of (1) local telephone networks and their natural monopoly and other characteristics; (2) the historic monopoly-era regulation of LECs; (3) the regulations that were adopted to develop competition in long distance and other services prior to the 1996 Act; and (4) the 1996 Act and the ensuing FCC rulemaking and other proceedings.

1. Local Telephone Service And Its Natural Monopoly And Other Characteristics.

Historically, telephone service has been provided by franchised incumbent LECs. Each had been granted a monopoly to establish a local telephone network and to offer local and other services in its territories. The principal incumbent LECs are the Bell Operating Companies ("BOCs"), which were part of the integrated Bell System before their divestiture from AT&T in 1984. Today, as a result of mergers, four BOCs (Verizon, SBC, Qwest and BellSouth) and their affiliates now own the telephone lines that serve more than 90% of local telephone customers in the country.[1]

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[1] Industry Analysis Div., Federal Communications Comm'n, *Trends in Telephone Service* 8-5 (Dec. 2000).

Local telephone service requires a vast array of facilities, systems, and capabilities. But at its most basic level, each incumbent's local telephone network consists of wires (called "local loops") that run from the telephones located in each home or business to a serving "wire center." That wire center contains a local "end office" switch which routes each call and which is connected by wires called "trunk" or "transport" facilities to the wire centers that serve other subscribers. The local networks of all incumbent LECs are interconnected either directly or through intercity ("long distance") transmission facilities -- such that any individual telephone subscriber can place or receive calls from any other subscriber.

Two characteristics of local telephone networks are particularly pertinent. First, they are dynamic. New facilities are constantly being constructed both to meet increased demand for telecommunications services (which has consistently grown at a faster rate than the economy as a whole) and to take advantage of technological innovations that allow basic services to be provided more efficiently and new services to be introduced. For these reasons, the incumbent LECs' networks contain a mixture both of facilities that reflect the latest generally available technologies and of older facilities that are approaching obsolescence. In recognition of this fact, the LECs, for financial accounting purposes, had (in 1996) written off over $23 billion of their net book investments in network facilities. Cox Reply Comments at 27 (May 30, 1996) (JA 171-72).

Second, most local network facilities enjoy substantial economies of scale. Order, ¶ 11 (JA 270-71). Indeed, certain facilities of local telephone networks have significant "natural monopoly" characteristics. For example, no firm today could economically replicate the network of wired local loops used

to serve residential and smaller business customers. *Id.* ¶¶ 10, 378 (JA 269-70, 308-09).[2]

2. The Monopoly Era Regulation Of LECs' Local And Long Distance Services.

For the past century, incumbent LECs have operated under regulatory statutes that required that their rates and practices be "just and reasonable" and "nondiscriminatory." *E.g.*, 47 U.S.C. §§ 201(b), 202(a). State commissions historically exercised jurisdiction over the LECs' calls that begin and end in the same state, and the FCC had this same authority over their rates for "interstate services." *Louisiana Pub. Serv. Comm'n* v. *FCC*, 476 U.S. 355, 360 (1986).

Prior to the late 1960's, the FCC and states engaged in no or very little cost of service regulation of the LECs' rates for individual services and facilities. Incumbent LECs then had monopolies over all the local and long distance telecommunications services and all the basic telephone sets and other "customer premises equipment" used in their service areas. Thus, while regulatory commissions required that rates for basic residential service be affordable, they otherwise generally exercised ratemaking authority only to establish the maximum levels of overall revenues and earnings that LECs' could realize from all their regulated services in aggregate – and to attempt to prevent LECs from earning monopoly profits on their overall operations.

Prior to 1944, this Court's constitutional law holdings had mandated that regulators exercise this authority based largely or entirely on the current cost of replacing the LECs' network. See *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602-05 (1944). Thereafter, there was a period of years in which the FCC and many state commissions sought to

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[2] Thus, the only alternative facilities that have anywhere been deployed to serve these customers use radio or existing cable television facilities. These technologies are many years away from being generally deployed.

regulate the LECs' earnings based on the "historic cost" of either the LECs' "prudent investment" or the prudent investment that was "used and useful." See, *e.g.*, *Charges for Interstate Tel. Serv.*, 38 FCC 2d 213, 226 (¶ 40) (1972). However, this system could not be administered in ways that promoted efficiency, and by 1990, the FCC and virtually all state commissions had abandoned their efforts to regulate the overall earnings of LECs. Instead, they adopted systems of "price caps" in which LECs aggregate rates were reduced each year to reflect increases in industry productivity. See *Rates for Dominant Carriers*, 5 FCC Rcd. 6786, 6792 (¶¶ 42-43) (1990).

3. The Regulations Adopted To Allow Competition In Long Distance And Other Telephone Services.

In the late 1960s, the FCC authorized new entrants to provide interstate long distance services and customer premises equipment in competition with the incumbent LECs.[3] These orders led to major changes in the regulation of LECs. Instead of regulating only the LECs' overall revenues or earnings, the FCC and state authorities adopted rules designed to assure that LECs provided individual services and facilities under rates, terms, and conditions that were nondiscriminatory and that would allow the authorized competition to develop where technologically and economically feasible. In addition, the LECs' conduct raised parallel issues under the antitrust laws.

The fundamental problem was that while there were components of long distance and the other authorized services that could be provided competitively, competition could not develop unless new entrants and their customers could economically interconnect with and use the local facilities that the LECs controlled. For example, even if a new entrant

[3] *See, e.g.*, *Microwave Communications, Inc.*, 18 FCC 2d 953 (1969); *Carterfone*, 13 FCC 2d 420 (1968).

constructed or leased an alternative long distance network, it could not provide retail long distance services unless it could use the LECs' local loops and other facilities to carry calls between its long distance network and its customers' premises. But where the incumbent LECs would be in competition with the new entrants, the LECs had both the incentive and the ability to discriminate against their competitors in pricing and providing access to these "bottleneck" local facilities that were essential "inputs" into their and their competitors' services.

There were a myriad of ever-changing ways in which LECs could, and did, use their control over essential facilities to prevent and delay competition with their services. But they all involved variations on classic "price-cost" squeezes in which LECs (1) charged retail prices that were at (or below) the costs that the LECs incurred in using their local facilities and providing the other components of the service and (2) prevented competitors from meeting these retail prices by actually (or effectively) charging them excessive rates for the use of local facilities that the LECs provided to themselves at their economic costs.

First, incumbent LECs could, and did, price the retail services that faced competition at competitive levels. At the urgings of the incumbent LECs, antitrust courts, and ultimately regulatory authorities, uniformly rejected claims that incumbent LECs had to price their retail services based on their historic costs, which are "sunk" and "unavoidable" and reflect the costs of inefficient facilities that no carrier would today choose to use to provide services. Some antitrust courts held the LEC prices would be lawful so long as they covered the "short run" variable or "incremental" costs that LECs incurred in providing additional units of service at issue. Those costs are very low in the

telecommunications industry because in the short run most costs of service are "fixed" and few are variable.[4]

And all courts and ultimately the FCC (and state regulators) held that retail prices would be lawful so long as they exceeded the costs determined under a particular "long run incremental cost" method that the Bell System had developed to determine the costs of its one long distance service (called "private line") that initially faced competition.[5] This method determined what it would cost efficiently to reconstruct and operate all of the additional facilities that must be in place for the Bell System to provide all its retail private line services. It thus measured all of the capital and operational costs of the total service – based on the most efficient available technologies and the existing demand for the service – and calculated the "average" of these forward-looking costs. *MCI Communications Corp.* v. *AT&T*, 708 F.2d 1081, 1115-16, 1124-25 (7th Cir. 1983). This method is often now referred to as "total service long-run incremental cost" or "TSLRIC." Order, ¶ 630 (JA 333).

Notably, while LECs were free to set their retail prices at these long run incremental costs, their local monopolies also gave them the ability and the incentive to engage in predatory pricing and to set retail prices below these levels – without incurring any losses in the short term. In particular, they could subsidize the below-cost portion of the retail rate with inflated prices for monopoly access or other services (which

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[4] *E.g.*, *Northeastern Tel. Co.* v. *AT&T*, 651 F.2d 76, 87 (2d Cir. 1981); *see also Barry Wright Corp.* v. *ITT Grinnell Corp.*, 724 F.2d 227, 232-33 (1st Cir. 1983) (Breyer, J.); P. Areeda & D. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 Harv. L. Rev. 697, 712 (1975).

[5] *See, e.g.*, *MCI Communications Corp.* v. *AT&T*, 708 F.2d 1081, 1123 (7th Cir. 1983); *Private Line Rate Structure Guidelines*, 97 FCC 2d 923, 945-46 (¶¶ 36-37) (1984); *C&P Tel. Co.*, 70 Md. P.S.C. 341 (Md. P.S.C. 1979).

they would justify by misallocating competitive costs to the monopoly services).[6]

Second, whether or not their retail rates covered their incremental costs, the incumbent LECs could – and did – engage in conduct that precluded new entrants from meeting or beating the retail long distance and other prices that the incumbent LECs charged.

Indeed, incumbent LECs engaged in a vast array of conduct that assured that their long distance and CPE competitors incurred dramatically higher costs in using the LECs' essential facilities than the LECs themselves incurred – which erected classic economic barriers to entry. R. Bork, *The Antitrust Paradox* 144-60, 329 (1978). The LECs' conduct included (1) charging their competitors excessive prices for the same facilities and features that the LEC used at cost; (2) forcing competitors to pay charges for items that were not used by LECs or their customers, (3) providing access to competitors that was inferior to that which the LEC enjoyed, and (4) artificially raising rivals' costs by refusing to make feasible changes to their networks that would allow rivals to offer new services. See *United States* v. *AT&T*, 524 F. Supp. 1336 (D.D.C. 1981). Because of the complexity of the local networks, it took massive decade-long proceedings, draconian regulations, and ultimately the restructuring of the telecommunications industry to address this discrimination.

For example, the FCC initially sought to introduce competition into the provision of telephone sets and other customer premises equipment merely by invalidating LEC prohibitions against interconnection of other firms' equipment. See *Carterfone*, 13 FCC 2d 420 (1968). The LECs responded by imposing complicated requirements that they justified on technical grounds – found to be shams years

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[6] *See, e.g.*, *LEC DS3 Serv. Offerings*, 4 FCC Rcd. 8634, 8339-40 (¶¶ 47, 50) (1989); *Private Line Rate Structure Guidelines*, 97 FCC 2d at 946-47 (¶ 37).

later[7] – that made it more expensive to interconnect competitors' equipment to the local network than to use LEC-provided equipment. Over the next two decades, the FCC responded to these and other forms of anticompetitive conduct by adopting increasingly more detailed technical regulations, separate subsidiary requirements, and non-structural safeguards designed to minimize the risks of discrimination, cost misallocations, and cross-subsidization. See, *e.g.*, 47 C.F.R. §§ 68.1-68.506; *Second Computer Inquiry*, 77 FCC 2d 384 (1980); *Joint Cost Order*, 2 FCC Rcd 1298, 1299-1300 (¶¶ 2-6) (1987).

The problems presented by the introduction of long distance competition proved far more intractable. For example, the FCC was unable to assure that the prices that the BOCs charged for their monopoly access services were nondiscriminatory and represented the economic costs that the BOCs incurred in using these same facilities in their retail interstate long distance services.[8] Indeed, the costing and cost allocation issues were largely outside the ability of the FCC even to address because of the then-existing division of regulatory responsibility over the BOCs' local facilities and the then-existing limitations on the services that competitors could offer.

For these and other reasons, the United States filed an antitrust suit against the Bell System. It sought and obtained (through a consent decree) an injunction that (1) required that the Bell System be split between its local operations (assigned to the BOCs) and its long distance operations (assigned to AT&T) and (2) barred the BOCs from providing interstate or intrastate long distance service for so long as they had local

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[7] *Litton Sys., Inc.* v. *AT&T*, 700 F.2d 785, 794-802 (2d Cir. 1983).

[8] *See, e.g.*, *MCI Telecomm. Corp.* v. *FCC*, 712 F.2d 517 (D.C. Cir. 1983); *ENFIA Order*, 91 FCC 2d 1079 (1982); *ENFIA Recons. Order*, 93 FCC 2d 739 (1983).

monopolies.[9] The decree thus ultimately assured that all long distance competitors received the same quality of access to essential LEC facilities at precisely the same costs. After this decree was implemented, intense long distance competition developed, leading to extraordinary price reductions and other consumer benefits.

Between 1984 and 1996, there were a variety of contexts in which competition was authorized in local toll and other services that depended on access to the LECs' monopoly facilities. Here, too, incumbent LECs urged, and regulatory bodies adopted, some form of long run incremental cost method to set the pricing "floor" for the LECs' retail services.[10] In addition, the FCC and state regulatory authorities established a "ceiling" for the wholesale rates based on TSLRIC or an indistinguishable method – sometimes with a markup that represented a reasonable allocation of the LECs' overhead and other "joint and common" costs.[11] As the FCC stated, this method is

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[9] *United States* v. *AT&T*, 552 F. Supp. 131, 160-70, 186-89 (D.D.C. 1982), *aff'd*, 460 U.S. 1003 (1983). The core of the long distance prohibition on the BOCs is now codified in § 271 of the Communications Act. 47 U.S.C. § 271.

[10] *See, e.g.*, 4 Colo. Code Regs. § 723-30; *Implementation of § 13-507 of the Public Utilities Act*, 162 P.U.R.4th 649 (Ill. C.C. 1995) (adopting Sections 791.80 & 791.90); *Competition in the Local Telecomms. Market*, slip op. at 30 (La. P.S.C. Mar. 15, 1996); *US WEST Communications, Inc.*, 165 P.U.R.4th 235, 288, 296 (Utah P.S.C. 1995), *amended*, 1995 WL 798880 (Utah P.S.C. Nov. 27, 1995); *Washington Utils. & Transp. Comm'n* v. *US West Communications*, Docket No. UT-950200, slip op. at 81-87 (Wash. U.T.C. Apr. 11, 1996); *see also* cases cited in *supra*, n. 11.

[11] *See, e.g., Open Network Architecture Tariffs*, 9 FCC Rcd. 440 (1993); *Open Access to Bottleneck Servs.*, 1995 Cal. PUC LEXIS 929, at *1-*3, *68, *94-*99 & App. A (Cal. P.U.C. Dec. 6, 1995); *Southern New England Tel. Co.*, 1995 WL 803837, at *8-*10, *65 (Conn. D.P.U.C. Dec. 20, 1995); *Communications Infrastructure Investigation*, 1995 WL 553009, at *1 (Haw. P.U.C. Aug. 14, 1995); *MFS Intelenet*, 1995 WL 848272 (Md. P.S.C. Dec. 28, 1995); *Long Run Incremental Costs*

"forward-looking" and based on the efficient "replacement costs" of the BOCs' facilities: that is, the "inputs [the BOC] would purchase today at the price it would have to pay to purchase those inputs today." *Open Network Architecture Tariffs*, 9 FCC Rcd. 440, 449-50, 454 (¶¶ 21, 36) (1993).

In addition, during this period, two different BOCs made filings with foreign regulators that argued that the incumbent monopolists in those countries should be required to grant access to new entrants at the long run incremental cost (LRIC) of providing the interconnections. They emphasized (1) that "because LRIC is forward-looking, competitors [would not be] paying for inefficiencies in an operator's network" and (2) there are now available computer "models" which will allow a "bottom up" determination of the "actual costs" of establishing and operating an efficient local network.[12]

4. The 1996 Act And The Ensuing Proceedings.

In the Telecommunications Act of 1996, Congress sought to open local markets to the possibility of the kind of competition that existed in long distance services. Congress enacted a new subchapter of the Communications Act that was designed rapidly to introduce whatever forms of local competition are now economically and technologically feasible. 47 U.S.C. §§ 251-261. It expressly preempts the state laws that had previously prohibited competitive local services. *Id.* § 253. But just as abolishing the Bell System's

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Methodology, 156 P.U.R.4th 1, 4-17 (Mich P.U.C. 1994); *MFS Intelenet*, 1995 Pa. PUC LEXIS 87, at *67 (Pa. P.U.C. Oct. 4, 1995). *See also* Order, ¶ 631 (JA 334-36) (discussing use of LRIC methodology by state commissions prior to 1996 Act).

[12] U S West International, A Framework For Effective Competition: Response To OFTEL's Consultative Document, at 12 (Mar. 30, 1995); *accord*, Comments of BellSouth Europe To The European Commission's Green Paper On The Liberalisation of Telecommunications Infrastructure (Mar. 15, 1995).

long distance monopoly could not itself create long distance competition, Congress recognized that broad-based entry in the entire local exchange market could not develop without both (1) the two entry vehicles that are at issue here and (2) the FCC rules that implement these provisions and that will govern the negotiation and state arbitration of specific interconnection agreements between LECs and new entrants.[13]

The Interconnection And Access Requirements. First, Congress understood that even when it is economically and technically feasible to construct complete alternative local telephone networks, local competition would not develop unless the incumbent LECs have affirmative duties to share their networks with competitors at economic costs. That is so because an essential feature of telephone service is that customers have the ability to place, and receive, calls from all other telephone subscribers. But a new entrant cannot offer this capability to customers unless the incumbent LEC "interconnects" with the network of a new entrant and allows the new entrant to use the incumbent's facilities to complete the calls that its customers place to the incumbent's subscribers. Section 251(c)(2) thus requires each incumbent LEC to "interconnect" with any requesting carrier at rates and on terms and conditions that are "just, reasonable, and nondiscriminatory" and that satisfy the requirement of § 252(d)(1) that rates be "based on the cost . . . of providing the interconnection or network element." 47 U.S.C. §§ 251(c)(2), 252(a)(1); see also *id.* §§ 251(b)(5), 252(d)(2) (requiring all competitive and incumbent LECs to transport and terminate calls at cost).

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[13] Congress also authorized a third method of entry – resale of retail telecommunications services – but it does not permit new entrants to provide the "exchange access" services required to serve the entire local services market. *See* 47 U.S.C. § 251(c)(4).

Second, because of the economies of scale and other economic characteristics of some local telephone facilities, Congress understood that it generally is not economic for competing firms to establish all of the facilities required to provide competing services. To be sure, there are retail functions and particular network facilities that can be provided efficiently by new entrants – as confirmed by the FCC Order on remand from *AT&T Corp.* v. *Iowa Utilities Board*.[14] But broad-based competition cannot develop unless new entrants also have the right economically to lease other facilities and functions from incumbents and to incorporate them into the separate networks that the new entrants establish. Order, ¶¶ 10-12 (JA 269-72).

For example, AT&T's strategy has been initially to serve most business customers by leasing unbundled local loops and transport facilities from LECs and by integrating them with AT&T's switching and other facilities. Similarly, in the many areas where AT&T owns no cable television systems or has not upgraded them to provide telephony, AT&T's strategy has been to lease existing, or new, combinations of loops, switching and transport from the incumbent and integrate them with AT&T's operator systems, directory assistance systems, and retail and customer care systems. AT&T has adopted these strategies even though the arrangements inherently impose enormous transaction and other costs on AT&T that incumbents do not bear.[15] The

[14] *See Local Competition*, 15 FCC Rcd. 3696 (1999) (determining that competitors now will not be "impair[ed]" without access to certain of the network facilities that had been designated as network elements in 1996).

[15] For example, when AT&T and other new entrants lease an unbundled local loop from the incumbent and combine it with an AT&T switch, the incumbent LEC has been deemed to satisfy the duty to provide unbundled elements on terms that are "just, reasonable and nondiscriminatory" if it causes substantial outages for "only" 5% of AT&T's customers. That is so even though LEC customers run no remotely comparable risk of service outages. *See SBC Communications*, 15 FCC Rcd. 18354, 18442-43 (¶ 177) (2000).

reason is that all the alternative means of entering local markets would require AT&T to incur radically higher costs and place it at far greater disadvantages relative to the incumbents.

In recognition of this fact, Congress gave new entrants the right to access and use the incumbent LEC facilities and functions on the same terms and at the same economic costs as does the LEC itself. In § 251(c)(3) of the Act, Congress provided that any requesting carrier can (1) access network elements on rates, terms, and conditions that are "just, reasonable, and nondiscriminatory" (47 U.S.C. § 251(c)(3)) and "based on the cost . . . of providing the . . . network element" (*id.* § 252(d)(1)(A)) and (2) "use" the element to provide any telecommunications services.

FCC Rulemaking Proceeding. In the FCC's rulemaking proceeding, it extensively dealt with the rules required to implement the single standard that § 252(d)(1) adopts to govern the setting of "just and reasonable" rates for both interconnection and network elements: that rates "shall be . . . based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable)" and "non-discriminatory." *Id.* § 252(d)(1).

In its Notice of Proposed Rulemaking, the FCC proposed that interconnection and network element rates be set under the Total Services Long Run Incremental Cost ("TSLRIC") method (see *supra* p. 8), and the FCC sought comment on this and other methods. The Antitrust Division and new entrants – supported by the testimony of distinguished economists – urged the adoption of TSLRIC. Order, ¶ 635 (JA 340-42).

For example, AT&T submitted detailed affidavits of Professors William Baumol, Janusz Ordover, and Robert

Willig, who explained that TSLRIC would measure the total forward-looking costs (including risk-adjusted capital costs) of providing the entire outputs of each of the network elements and interconnection arrangement that are authorized. They stated that TSLRIC represents both the prices that would be charged for such elements if they were provided competitively and the economic costs that the incumbent LECs would themselves incur in using the elements to provide their competing retail services.[16]

By contrast, most (but not all) of the incumbent LECs urged the adoption of a "historic cost" standard in which rates would be based on the costs that LECs incurred in the past and that are recorded in the LECs' ratemaking "books of account." Order, ¶ 638 (JA 344-46). LECs did not advance this position on grounds of economic efficiency or of rational competitive policy. Rather, they maintained that they had a right (under an alleged implicit "regulatory compact") to recover their historic cost and that adoption of a historic cost standard to establish network element rates would assure that these costs are recovered and not "stranded." However, the LECs' economists all emphasized that long run incremental cost was the proper starting point and the method that would foster economic efficiency – so long as the method included a markup for the LECs' "joint and common costs" and that the depreciation and return on investment component of the rates reflected all the risks that LECs faced.[17]

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[16] AT&T Comments (May 16, 1996), William Baumol, Janusz Ordover, and Robert Willig Aff. at 2-15 (JA 59-75); AT&T Reply Comments (May 30, 1996), William Baumol, Janusz Ordover, and Robert Willig Reply Aff. at 2-3, 7 (JA 141-48).

[17] *See* Bell Atlantic Comments (May 16, 1996), Robert Crandall Decl. at 6 (JA 84-85); *see also id.*, Jerry Hausman Aff. at 2-3 (JA 89-92); GTE Comments (May 16, 1996), Edward Beauvais Aff. at 2-4, (JA 103-07); US WEST Comments (May 16, 1996), Robert Harris and Dennis Yao Report at 5 (JA 136-38).

For example, Dr. Alfred Kahn suggested that LECs had a constitutional or equitable right to recover their historic book costs to the extent that they "exceed forward-looking costs." But even if they had this right, Dr. Kahn stated that it would be "preferable on grounds of pure economic efficiency if these justified [historic] costs" were not recovered "in the prices of [the network element and interconnections] inputs" purchased by LEC competitors. Rather, they should be recovered in competitively neutral surcharges "in the prices for final products or services only."[18]

LEC economists also criticized the TSLRIC proposals of AT&T and others on the ground that TSLRIC would determine the costs of reengineering LEC facilities on a "blank slate" that ignored all the characteristics of the existing networks. They complained that this "scorched earth" method could require determinations of whether alternative technologies that would use very different facilities and layouts (*e.g.*, wireless systems or cable television) had become the most efficient means of providing service.[19] No LEC economist proposed a method that would determine the costs for providing network elements based on the current prices of replicating the LECs' existing facilities – many of which are approaching obsolescence.

The FCC's Local Competition Order. In the FCC's Order, it adopted the TSLRIC standard, but made several adjustments to it to reflect the concerns that had been raised by the LECs' economists. And because the method was primarily being applied to network elements and not services,

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[18] Bell Atlantic Reply Comments (May 30, 1996), Alfred Kahn and Timothy J. Tardiff Decl. at 8 (JA 160-62).

[19] Bell Atlantic Reply Comments (May 30, 1996), Alfred Kahn and Timothy J. Tardiff Decl. at 3-5 (JA 153-57); USTA Reply Comments (May 30, 1996), Jerry Hausman Reply Aff. at 10-11 (JA 200-02); US WEST Reply Comments (May 30, 1996), Robert Harris Reply Aff. at 8-9 (JA 206-09).

the FCC labeled its method Total Element Long Run Incremental Cost or TELRIC. Order, ¶ 678 (JA 378-79).

First, the FCC found that long run incremental costs represent the economic costs that incumbent LECs in fact incur when they provide elements and interconnections to competitive carriers. Order, ¶¶ 679, 685 (JA 379-80, 383-84). The FCC concluded that to the extent that these TELRIC rates would be lower than those set under a historic cost method and residual costs were not recovered, it would be inefficient and anticompetitive to mark up network element and interconnection rates to recover them. The FCC found that any such markup would subject new entrants to price squeezes, would encourage inefficient entry, and would artificially inflate retail rates. It thus concluded that (consistent with Dr. Kahn's testimony) if there were residual unrecovered costs, they should be recovered, if at all, in competitively neutral surcharges or in LEC rates for other services. *Id.* ¶¶ 706-707 (JA 399-401). The FCC's regulation thus expressly barred any consideration of the LECs' "[e]mbedded" historic costs in setting network element and interconnection rates. 47 C.F.R. § 51.505(d)(1).

Second, the FCC addressed the LECs' other concerns. It provided that the TELRIC-based rates should recover all of the total long run forward-looking costs of satisfying the entire demand for the element – plus a reasonable allocation of overhead and other joint and common costs attributable to the provision of the element. Order, ¶¶ 694-698 (JA 388-92). In response to the LECs' concerns, the FCC similarly made it explicit that the depreciation and return on investment components of the rates should reflect the "declines in value of capital goods" due to technological innovations and all the other risks of operating under such a regime. *Id.* ¶¶ 686-687 (JA 384-85).

The FCC next addressed the concerns that the use of a "blank slate" method would be administratively unwieldy and could provide disincentives for the construction of alternative

networks. Rather than basing costs on the "least-cost, most efficient network configuration and technology currently available," it required that rates be set based on "the incumbent LECs' current wire center[s]": that is, that state commissions assume that a new reconstructed network would deploy switches in the same locations that incumbent LECs currently use and that local loops and transport facilities would continue to be terminated at these same locations. The FCC stated that the "reconstructed local network [must otherwise] employ the most efficient technology for reasonably foreseeable capacity requirements." Order, ¶¶ 683-685 (JA 382-84). The FCC did not believe that this qualification would today represent a substantial departure from economic efficiency, for the FCC found that this method "most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants." *Id.* ¶ 685 (JA 384).

Finally, the FCC rejected a method in which the rates would be "based on the existing network design and technology that are currently in operation." Because any such method would set rates based on the LECs' "existing operations" and prices for "inefficient or absolute network design and technology," the FCC found that "[t]his is essentially an embedded cost methodology." Order, ¶ 684 (JA 383).

The Subsequent Independent Adoptions of TELRIC or Its Equivalent. Following the adoption of the FCC's Order, numerous regulatory bodies independently adopted cost standards that were indistinguishable from TELRIC in all respects relevant to this appeal. Indeed, certain of the incumbent LECs themselves advocated this very approach for determining the costs of providing network elements and interconnections.

First, in addition to requiring cost-based interconnection, the 1996 amendments to the Communications Act required the adoption of new competitively neutral methods to

promote universal service: that is, the funding of the below-cost rates that assure that local telephone service is affordable in rural and high cost areas. See 47 U.S.C. § 254. This, too, required the development of a method to determine all the costs of providing local telephone service, including the underlying network elements. To make this determination, a Benchmark Cost Proxy Model was developed by a consortium of carriers that, at different times, included incumbent LECs that are affiliates of each of the four firms that collectively now own over 90% of local telephone lines. Like TELRIC, this model determines the forward-looking costs of providing network elements by reconstructing "all plants . . . at a single point in time using the existing wire centers of incumbents" and the "most efficient available technology and network design."[20] In its subsequent *Universal Service Order*, the FCC adopted this forward-looking methodology,[21] and the Fifth Circuit upheld that policy choice.[22]

Second, after the FCC's local competition rules were adopted, the Eighth Circuit stayed the FCC's pricing rules on the jurisdictional ground that the FCC had no authority to adopt a cost standard that governs arbitration proceedings conducted by state commissions. During the three-year period in which the stay was in effect and before this Court reversed the Eighth Circuit's jurisdictional holding (*AT&T Corp.* v. *Iowa Utilities Board*, 525 U.S. at 730), state regulatory commissions were free to adopt whatever pricing

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[20] *See Universal Serv. Order*, 12 FCC Rcd. 8776, 8903-16 (¶¶ 232-250) (1997) (describing cost model developed by LECs); *see also Platform Order*, 13 FCC Rcd. 21323, 21364-83 (App. A) (1998).

[21] *Universal Serv. Order*, 12 FCC Rcd. at 8916 (¶ 250).

[22] *See Texas Office of Pub. Util. Counsel* v. *FCC*, 183 F.3d 393 (5th Cir. 1999).

methodology they believed most appropriate. Most adopted TELRIC.[23]

Third, during this same period, the European Commission adopted recommended standards to govern interconnection with incumbent telephone monopolies in its member states. It adopted a method which it labeled "forward-looking long run average incremental cost." The European Commission stated that its method will ultimately require "building 'bottom-up' models whereby an economic/engineering model of an efficient network is developed, from which interconnection costs can be calculated by aggregating the costs of individual network elements," and by including "markups" to recover "the forward looking joint and common costs of an efficient operator." Commission of the European Communities, *Commission Recommendation on Interconnection in a Liberalised Telecommunications Market* §§ 3.3, 3.5, 1997 C(97)3148. The European Commission stated that these establish the incumbents' "economic or 'real'" costs of providing interconnection and represent the rates that would be charged in a competitive market. *Id.* § 3.3. This is the cost standard that BellSouth and U S West (now "Qwest") had urged European regulators to adopt. See *supra* p. 12 & n. 12.

5. The Eighth Circuit's Decision On Remand.

In *AT&T Corp.* v. *Iowa Utilities Board*, 525 U.S. 366 (1999), this Court reversed the Eighth Circuit's 1997 decision that had vacated TELRIC and many of the FCC's other local competition rules. This Court rejected the Eighth Circuit's jurisdictional holding and held that § 201(b) of the Act gives the FCC jurisdiction to adopt rules that "carry out" all the Act's pricing and other local competition provisions. *Id.* at 378. The Court further held that the Eighth Circuit had erred in vacating the FCC rule (51.315(b)) that required incumbent

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[23] *See* C.A. Docket Entry 1099949-1, Apps. B and C (Mar. 9, 1999); *see also* P. Huber et al., *Federal Telecommunications Law* § 2.4.4.1, at 185 (2d ed. 1999).

LECs, upon request, to provide new entrants with existing combinations of network elements. *Id.* at 394-95. The Court ruled that the FCC has authority to adopt rules that prevent discrimination and that the final sentence of § 251(c)(3) does not bar the FCC from ordering the LECs to provide combinations of elements when that was found to be an appropriate means of preventing discrimination. *Id.* The Court then remanded the case to the Eighth Circuit to address the LECs' substantive challenges to the FCC's pricing rules and to reconsider its other holdings in light of the Court's rulings. *Id.* at 397.

On remand, the Eighth Circuit again invalidated the FCC's TELRIC regulation. Pet. App. 9a. Although it rejected the LECs' claim that the Act required a historic cost method and held that a forward-looking cost method is consistent with the Act's terms and "stated purpose," the court held that the regulation violated the plain terms of the Act insofar as it required that forward-looking determinations be based on the costs of efficiently replacing the LECs' facilities. *Id.* at 7a-8a. While the Eighth Circuit vacated only the subsection of the FCC's rule (51.505(b)(1)) that required that rates be set on this basis, the court remanded the entire rule to the FCC for reconsideration in light of the Eighth Circuit's decision. *Id.* at 14a.

The Eighth Circuit also refused to vacate its earlier decision that invalidated the FCC rule that required the incumbent LECs to effect technically feasible new combinations of network elements when the requesting carrier pays all the costs of the new combinations. Pet. App. 25a (vacating 47 C.F.R. § 51.315(c)-(f)). The Eighth Circuit again held that this rule is inconsistent with the final sentence of § 251(c)(3). *Id.*

SUMMARY OF ARGUMENT

The Eighth Circuit erred in vacating the two FCC regulations at issue. Each regulation is consistent with the

"particular statutory language at issue, as well as the language and design" of the local competition provisions of the Communications Act "as a whole." *Kmart Corp.* v. *Cartier, Inc.*, 486 U.S. 281, 291-92 (1988). Each further represents an eminently "reasonable" judgment on the "policy choice" that Congress committed to the FCC. *Chevron, U.S.A., Inc.* v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837, 845 (1984).

1. There is no basis for the Eighth Circuit's holding that the 1996 Act prohibits the FCC from requiring that interconnection and network element rates be based on today's prices for efficiently replacing those facilities and functions. This is the "cost of service" ratemaking standard that this Court formerly required, and now expressly permits, regulatory bodies to use when they are determining the maximum revenues and earnings that a regulated firm can realize from all its regulated services.

Moreover, the object here is to assure that incumbent LECs price individual essential services at levels that will allow efficient competition in the "unshared" aspects of local service by preventing "price squeezes" from foreclosing this competition. Antitrust courts, the FCC, other federal regulatory bodies, state utility commissions and other tribunals have long used replacement cost methods to determine the economic costs of individual services and facilities for this very purpose.

In holding that the terms of § 252(d)(1) bar the use of efficient replacement costs in setting these rates, the Eighth Circuit rested on the ground that § 252(d)(1) requires that the "just and reasonable" rates be based them on the costs of providing "*the* interconnection or network element (whichever is appropriate)." 47 U.S.C. § 252(d)(1) (emphasis added). The Eighth Circuit concluded that the use of the modifier "the" means that the rates must be based on the actual facilities that the new entrant will use, not "hypothetical" facilities that embody the most efficient

available technology. In the Eighth Circuit's view, it followed that TELRIC is invalid.

First, this decision would be erroneous even if the Eighth Circuit had correctly construed the term "the." For the Eighth Circuit was simply wrong in concluding that replacement cost methods do not determine the "costs" that the LECs incur in providing their "actual" existing network facilities today. The FCC expressly found precisely the opposite. Further, the decisions of antitrust courts, state and federal regulatory bodies, and the European Commission have all concluded that TELRIC and other replacement cost methodologies determine the "economic" and "real" costs to a firm of providing its actual facilities today.

Second, even if that were not the case, the Eighth Circuit is also wrong that the Act unambiguously mandates that costs be set on the basis of the "actual facilities" of the "incumbent LEC" that will be providing them. Indeed, in context, the term "the" merely requires that rates be based on the particular type of facility at issue – *e.g.*, an interconnection or a local loop as opposed to another network element. Further, under the Act and the FCC's rules, LECs provide competitors not with actual facilities, but with "features, functions, or capabilities." In short, the Act's terms do not permit, much less compel, a reading in which rates have to be based on the "actual facilities" of any particular LEC.

Finally, the Eighth Circuit's decision would require outcomes that are, at best, far less reasonable than the FCC's approach and, at worst, absurd. Under its decision, forward-looking cost determinations would be required to be made under one of two methods. The first is the "cost of reproducing obsolete technology." Pet. App. 7a. It is a method that would inflate rates far above TELRIC and that Justice Brandeis long ago condemned as the worst of all possible methods. *Missouri ex rel. Southwestern Bell Tel. Co.* v. *Public Serv. Comm'n*, 262 U.S. 276, 312 (1923) (Brandeis, J., concurring in the judgment). The second is a short run

incremental cost or other method that is dramatically less favorable to LECs than TELRIC. That the Eighth Circuit would require a choice between two extreme opposing outcomes underscores that TELRIC rests on a reasonable interpretation of the Act to which the Eighth Circuit was required to defer.

2. The Eighth Circuit similarly erred in refusing to reinstate the FCC rules (51.315(c)-(f)) that require incumbent LECs to combine network elements when that is technically feasible and the requesting carrier pays all costs of the combination. The FCC adopted this rule because it found – based on the record and its experience – that a refusal by incumbent LECs to deal on these terms would violate the requirement (of the first sentence of § 251(c)(3)) that they provide access on terms that are "just, reasonable, and nondiscriminatory." The Eighth Circuit did not and could not question this finding. However, it refused to reinstate the rule because it concluded that the next sentence of § 251(c)(3) – which requires the LECs to provide elements "in a manner that allows new entrants to combine them" – bars the FCC from preventing discrimination by ordering LECs to provide combinations of elements. But this Court unanimously rejected this proposed construction of § 251(c)(3) in *AT&T Corp.* v. *Iowa Utilities Board*, 525 U.S. at 394-95.

ARGUMENT

I. TELRIC IS A REASONABLE METHOD OF IMPLEMENTING THE MANDATE THAT INTERCONNECTION AND NETWORK ELEMENT RATES BE BASED ON THE COST OF PROVIDING THEM.

The FCC's TELRIC regulation epitomizes the policy determinations that Congress delegated to a federal agency. *Chevron, U.S.A., Inc.* v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837, 844-45 (1984). TELRIC represents the best

practical – and assuredly a reasonable – method of implementing the statutory requirement that rates for interconnections and network elements be "just and reasonable," "based on the cost of providing [them]," and "nondiscriminatory." 47 U.S.C. § 252(d)(1).

Specifically, the TELRIC regulation provides that, in calculating these rates, state commissions cannot "consider" the LECs' retail costs and their historic "embedded costs," which are defined as "the costs that the incumbent LEC incurred in the past and that are recorded in the incumbent LECs' books of accounts." 47 C.F.R. § 51.505(d)(1), (2). Instead, the regulation provides that the rates for each type of element should be based on (1) "the most efficient telecommunications technology [that is] currently available, and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers" and (2) the "total quantity of the facilities and functions that are directly attributable" to meeting the total existing demand for that element, "taking as a given the incumbent LEC's provision of other elements." *Id.* § 51.505(b). The rates are to include a "reasonable allocation" of joint and common costs and the LECs' capital costs (risk adjusted return on investment and economic depreciation). *Id.* §§ 51.505(a), (b)(2)-(3).

Under this standard, States are thus to set rates for individual network elements – *e.g.*, the local loop – based on the capital costs that an efficient carrier would incur today if it efficiently reconstructed the facilities that connect telephones in homes and business to the LECs' existing wire centers. Under the FCC's rules, states obviously need not calculate rates on a loop-by-loop or customer-by-customer basis, but establish averaged statewide rates that will vary depending only on the population density of the particular area in which the loop is provided (with the state required to establish rates for a minimum of three levels of density). *Id.* § 51.507(f).

The Eighth Circuit invalidated this regulation on a nominally narrow ground. It rejected the incumbent LECs' claim that this regulation is unlawful because it does not guarantee that LECs will recover all of their embedded "historic" costs in their interconnection and network elements rates. Pet. App. 9a-10a. The Eighth Circuit held that that would be inconsistent with the Act's "stated purpose[]" of promoting competition. *Id.* at 10a. However, the Eighth Circuit vacated the subsection of the rule (51.505(b)(1)) that required that forward-looking determinations be based on the most efficient available technologies, and the Eighth Circuit remanded the entire rule to the FCC for reconsideration. *Id.* at 14a.

The Eighth Circuit rested this holding on the ground that § 252(d)(1) provides that "just and reasonable" rates for interconnections and network elements be based on the "cost of providing *the* interconnection or network element (whichever is applicable)." Pet. App. 6a; JA 22-23. The Eighth Circuit concluded that the statute's use of the definite article "the" in this context meant that Congress has "directly addressed" the precise question at issue (*Chevron, U.S.A., Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984)) and mandated that interconnection and network element rates be based on the LECs' "actual facilities," not on a "hypothetical" and "fantasy" network that does not now exist. In the Eighth Circuit's view, it followed that the TELRIC regulation is invalid. Pet. App. 7a-8a.

This holding is plainly wrong. *First*, even if the Eighth Circuit's construction of the Act were correct, it would not support its invalidation of the regulation. The FCC here found, as decades of prior decisions establish, that TELRIC and other efficient replacement cost methodologies determine a LEC's costs of providing its "actual" services and facilities. *Second*, the Eighth Circuit's interpretation of the statutory text is not a remotely plausible one, much less the only possible one, and the Act is reasonably read to permit

determinations of the cost that any firm would incur today in replacing and operating the LEC facilities in question. *Third*, the Eighth Circuit's decision would produce the absurdity that interconnection and network element rates would be required to be set under either uniformly condemned standards that would inflate rates far above TELRIC or other standards that would be far less favorable to LECs than TELRIC.

A. TELRIC Determines The Costs Of Providing The LECs' "Actual Facilities."

Although the Eighth Circuit's decision rests on a misinterpretation of the Act's "plain meaning," the FCC's TELRIC regulation would be valid even if the Eighth Circuit were correct that § 252(d)(1) requires rates to be set based on the LECs' costs of providing their "actual" facilities. The FCC repeatedly found that TELRIC determines the "economic costs" of the incumbent LECs in providing their facilities. Order, ¶¶ 675, 679 (JA 377, 379-80). It found that "[i]ncremental costs are the additional costs . . . that a firm will incur . . . by producing an additional quantity of the good or service." *Id.* ¶ 675 (JA 376-77). It found that TELRIC will result in prices that "most closely represent[] the incremental costs that incumbents actually expect to incur in making network elements available to new entrants," and that it "should facilitate competition on a reasonable and efficient basis" by allowing new entrants to use essential facilities "based on costs similar to those incurred by the incumbents" who will, of course, use these same actual facilities. *Id.* ¶¶ 679, 685 (JA 380, 384). TELRIC simply was not intended to do anything other than measure a LEC's costs of providing its "actual facilities."

Further, even if the FCC had not expressly so found, it is well settled that replacement cost methodologies measure the costs that firms incur in providing their "actual" goods or services. Indeed, the 1996 amendments to the Communications Act were enacted against the background of literally decades of decisions that so concluded. Ironically,

these are same decisions and principles that required the Eighth Circuit's correct holding that the Act does not mandate a "historic cost" methodology.

First, as the Eighth Circuit noted, the term "cost" has no single meaning. It is a "chameleon, capable of taking on different meanings" in different contexts. *Strickland* v. *Commissioner, Maine Dep't of Human Servs.*, 48 F.3d 12, 19 (1st Cir. 1995). Similarly, this Court has held that "cost" is a term that "connotes the use of judgment and has no technical meaning." *National Ass'n of Greeting Card Publishers* v. *United States Postal Serv.*, 462 U.S. 810, 832 (1983).

In addition, as the Eighth Circuit implicitly recognized, here the context is quite specific. Section 252(d)(1) does not direct a determination of the "cost" of "the" network element or interconnection. The determination that is required is of the "cost . . . of *providing* the interconnection or [the] network element." 47 U.S.C. § 252(d)(1)(A) (emphasis added). So even if the modifier "the" requires a focus on the LECs' "actual facility," the question is not what is the cost of the facility. The question is what is the cost of "providing" it.

Second, as the Eighth Circuit also noted, the costs of "providing" the incumbent LECs' "actual facilities" need not – and in this context should not – be based on the amount of the LECs' historic investments in the facilities. There is "no truism in economics more elementary" than that these historic costs "are to be ignored" in determining the economic costs incurred in providing a firm's actual goods and services. A. Kahn & W. Shew, *Current Issues In Telecommunications Regulation: Pricing*, 4 Yale J. on Reg. 191, 225 (1987). The past investments are "sunk" and "unavoidable," and the economic measure of the costs are the incremental "current" or "future" operating and capital costs that the firm incurs as a result of offering its goods and services now and in the future. *MCI Communications Corp.* v. *AT&T*, 708 F.2d 1081, 1116-17 (7th Cir. 1983).

Third, the costs that are considered incremental will vary depending on the size and timing of the increment. 1 A. Kahn, *Economics of Regulation* 70-71 (2d ed. 1988). The law measures incremental costs in one of two different ways. "Short run" incremental cost methods reflect the fact that the firm has sunk fixed investments that will not be immediately replaced, that will often be less cost-effective than currently available alternatives, and that will require that the firm meet current demand through incremental investments and expenditures that firms with newer plants would not make. A short run incremental cost method assigns no costs to the sunk fixed investments and calculates only the incremental operating expenses and capital costs that will result from meeting current or future demand in the short run. *Northeastern Tel. Co.* v. *AT&T*, 651 F.2d 76, 86 (2d Cir. 1981). It is a particularly appropriate method when the sunk investments will never be replaced. 1 Kahn, *supra*, 72-73.

By contrast, a "long run" incremental cost method selects a period of time that is long enough for all costs to be variable. This method determines all the fixed and variable operating and capital costs of providing a facility or service in a competitive market. In competitive markets, prices will tend toward long run incremental cost, for if a firm with less efficient facilities charged higher prices, it would immediately be undercut by a new entrant that used the most efficient available assets. *MCI Communications Corp.* v. *AT&T*, 708 F.2d 1081, 1116-17 (7th Cir. 1983); 1 Kahn, *supra*, 67.

By determining the cost of efficiently replacing the facilities of an incumbent firm, long run incremental cost methods make cost determinations based on the value of the incumbent's actual existing facilities. For example, if a firm purchased a computer three years ago for $1000 and an equivalent computer can be purchased today for $500, the value of the firm's investment in the computer today is $500. The cost to the firm of using its "actual computer" in providing its services is thus no more than the sum of the

operating expenses and the capital costs (*i.e.*, economic depreciation and return on investment) of the $500 computer that is available in the market today. See W. Baumol & J. Sidak, *Towards Competition In Local Telephony* 60 (1994). "A competitive marketplace values assets, not at their historical price, but at their *replacement* value – the present cost of obtaining the identical service that the old asset provides." S. Breyer, *Regulation and Its Reform* 38 (1982).

For these reasons, the law could not be clearer that replacement cost is a measure of the cost of a firm's actual goods or services and that a rate set on this basis is "just and reasonable" and "based on the cost" of providing the firm's actual goods or services. In particular, replacement cost has long been one of the two basic recognized methods of cost of service ratemaking. J. Bonbright et al., *Principles of Public Utility Rates* 119 (2d ed. 1988). It is also the measure favored by economists. See D. Spulber, *Regulation and Markets* 276 (1989).

Indeed, this Court formerly required state and federal commissions to regulate a firm's maximum overall revenues under "replacement" or "reproduction" cost standards. See *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299, 308-09 (1989). While these terms were "variously defined," the most "useful" and only economically sound definition was "the minimum amount [of investment] necessary to create at the time of the inquiry a modern plant capable of rendering equivalent service." *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 622 n.3 (1944) (Reed, J., dissenting).[24] In Justice Breyer's words, that method "bear[s] an uncanny resemblance to TELRIC." *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. at 424 (Breyer, J., concurring in part and dissenting in part). While the requirement to set rates under this standard ended in 1944,

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[24] *See* J. Siegel & J. Shim, *Dictionary of Accounting Terms* 343 (2d ed. 1995) (defining replacement cost as the "current cost to replace the service potential of an existing asset").

this Court has since held that replacement cost continues to be a permissible method of determining a utility's cost of service, and of setting "just and reasonable" rates. *Mobil Oil Exploration & Producing Southeast Inc.* v. *United Distribution Cos.*, 498 U.S. 211, 224-25 (1991); see *Duquesne Light Co.* v. *Barasch*, 488 U.S. at 308-09.

Similarly, replacement cost is the cost of service method that the Interstate Commerce Commission and later the Surface Transportation Board adopted to set the "reasonable" rate that a railroad can charge captive shippers under the 1980 amendments to the Interstate Commerce Act. See, *e.g.*, *Coal Rate Guidelines*, 1 I.C.C.2d 520, 542-43 (1985). In particular, these agencies use a method which calculates the investments and expenditures that a railroad would make if it replaced all the facilities required to provide only the transportation services used by that shipper. Courts have upheld this standard because it is a reasonable determination of the costs that a railroad incurs in serving these shippers. See, *e.g.*, *Consolidated Rail Corp.* v. *United States*, 812 F.2d 1444, 1453-57 (3rd Cir. 1987); *Potomac Elec. Power Co.* v. *ICC*, 744 F.2d 185, 194-95 (D.C. Cir. 1984). TELRIC is expressly based on this method.[25]

Even more fundamentally, in contrast to the provisions at issue in the foregoing cases, the object of § 251 is to assure that incumbent LECs cannot use their control over essential facilities to effect price-cost squeezes that prevent competition with their retail services. Order, ¶ 679 (JA 379-80). And, as explained in detail above, the 1996 Act was enacted against the background of antitrust, state, regulatory

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[25] Indeed, the ICC/STB method differs from TELRIC only because it effectively allocates all overhead and "joint and common" cost to the service, thus establishing the "stand-alone cost" of providing only a single service. Notably, while TELRIC provides for only a "reasonable" allocation of "joint and common costs," it provides that "stand alone cost" is the maximum rate that can be charged for any network element. 47 C.F.R. § 51.505(c)(2)(i).

and FCC decisions that had adopted efficient replacement cost methods to determine the costs, and lawful prices, of individual services of LECs and other incumbent firms for this very purpose. See *supra* pp. 6-12.

The point is also confirmed by decisions since the 1996 Act was passed. For example, as noted above, during the period in which the FCC's pricing rules were stayed on jurisdictional grounds, state commissions were free to use any cost of service ratemaking method and most independently adopted TELRIC or a similar efficient replacement cost standard. See *supra* pp. 20-21. Incumbent LECs had themselves urged European regulators to set interconnection rates under this cost standard, and the European Commission recently agreed. It concluded that the "real" and "economic" costs that incumbent telephone carriers incur in providing interconnections to its existing network should based on the costs of a "bottoms up" reconstruction of the facilities with the most efficient generally available technology. See *supra* p. 21.

Finally, it is ironic that the Eighth Circuit would assert that TELRIC is unlawful because it is "hypothetical" and putatively rests on "fantasy." As Drs. Baumol, Willig, and Ordover explained below, all ratemaking methods rest on "hypothetical constructs," but TELRIC does so to a far lesser extent than the other methods that were proposed. Baumol et al. Reply Aff. at 6 n.4 (JA 147). It rests on the "actual prices" that LECs actually pay today for generally available equipment that is more efficient than their older existing facilities. *Id.* at 7 n.5 (JA 147). This determines the value of the "actual facilities" that the BOCs are providing. The "fantasy" would be to ignore these actual costs.

Indeed, the Eighth Circuit's suggestion is peculiarly misplaced for another reason. The FCC addressed the LEC's stated concerns about the hypothetical nature of this methodology by directing that the determinations be based on the incumbent LECs' existing wire center locations. Order,

¶¶ 682-685 (JA 381-84); 47 C.F.R. § 51.505(b)(1). This fully responded to the LECs' concern that regulatory bodies could be required to assess whether wireless or cable television based services were more efficient than the existing LEC networks, and it represented a "pragmatic adjustment[]" that was uniquely committed to the FCC's discretion. *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283, 329 (1974); *FPC* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942).

In short, TELRIC determines the costs of providing the "actual" interconnection and network elements that LECs provide to requesting carriers. Thus, the regulation would be valid even if the Eighth Circuit had correctly construed § 252(d)(1).

B. The Eighth Circuit Misconstrued § 251(d)(1).

However, the Eighth Circuit's construction of § 252(d)(1) is wrong for two reasons. First, by using the word "the" to modify "interconnection" and "network element," Congress has not "directly spoken" to the issues and unambiguously required that ratemaking determinations consider only the "actual facilities" that the LEC will provide. *Chevron, U.S.A., Inc.* v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842 (1984). Second, even if the modifier "the" had the significance that the Eighth Circuit gives it, the other terms of the Act foreclose any claim that the ratemaking inquiry must be directed at the costs of providing the LECs' "actual facilities."

1. Section 252(d)(1) provides as follows:

> Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) and section 251 of this title, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section 251(A) shall be (i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing *the* interconnection

> or network element (whichever is applicable), and (ii) nondiscriminatory . . . .

47 U.S.C. § 252(d)(1) (emphasis added).

When considered in context, the modifier "the" merely directs the state commission to make its cost determinations based on the particular type of facilities that is "applicable" to that proceeding: *e.g.*, an interconnection as opposed to a local loop or other network element. A state will be determining the cost of providing "the" network element – *e.g.*, a local loop – if it determines the cost that any efficient carrier would incur in constructing and operating local loops in the particular area or type of area. There is nothing in the statutory text that compels a holding that the determinations be made based on the costs specific to the particular incumbent LEC whose facilities will be provided, much less that they be based on the specific "actual facilities" at issue.

For example, almost every State in the nation has a number of different incumbent LECs, with each having previously been franchised exclusively to serve its own separate territories in the State. Under the terms of § 252(d)(1), it is plainly permissible for network element rates to be based on data that is not specific to any of the individual LECs in a state. Rates can be based on statewide average costs of providing facilities in areas with particular population densities, regardless of the specific incumbent LEC that operates within it or the specific "actual facilities" that a specific incumbent LEC has deployed. A state order that set statewide local loop rates on such a basis would be based on the cost of providing "the" network element, and would satisfy the text of the Act, whether or not the determination could be characterized as based on the costs of any LEC's "actual facilities."

By contrast, under the Eighth Circuit's interpretation, states would be required to determine separate rates, on a loop-by-loop basis, for each of the nation's millions of local loops –

with different rates for each loop in, for example, Bethesda, Maryland. For it is then, and only then, that a requesting carrier could be said to be paying rates that are based on what the Eighth Circuit described as the "specifically requested existing network elements that the competitor will in fact be obtaining" from the incumbent LEC. Pet. App. 8a. Statutes cannot be construed to produce such absurdities. *Haggar Co.* v. *Helvering*, 308 U.S. 389, 394 (1940).

2. Further, the Eighth Circuit's construction is wrong even apart from its views on the significance of the use of the modifier "the." Even if word "the" directs the state to the precise "interconnection" or "network element" that has been required, § 252(d) does not require or permit a determination of the cost of providing a LECs' "actual facility." For under the terms of the Act and of the FCC's rules, no incumbent LEC provides an "actual facility" to a requesting carrier. Rather, it provides "features, functions, and capabilities" of facilities that the incumbent LEC owns, operates, and controls.

This follows from the Act's explicit terms. It defines "network element" as either "a facility or equipment used in the provision of a telecommunications service" or "the features, functions, and capabilities that are provided by means of such facility or equipment." 47 U.S.C. § 153(29). The particular network elements that an incumbent LEC is required to "make available" are those which the FCC's regulations designate under the standards of § 251(d)(2). The FCC's Order makes it explicit that it has not required incumbent LEC to provide any actual "facility or equipment" to requesting carriers. Rather, the FCC's Order expressly states that LECs' duty to provide the FCC-designated elements does not "alter the incumbent LEC's physical control" over the facilities nor its "duty to repair and maintain [them]." Order, ¶ 258 (JA 279). Under the FCC's rules, the LEC retains possession and control of the facilities and equipment, and the LEC is providing specific "outputs" or

capacity from its facilities and equipment to the requesting carriers. *Id.* ¶¶ 258-270, 690-695 (JA 278-87). So it quite plainly is the case that, under the FCC's Rules and under the Act, the "network elements" that are being provided are not "actual facilities," but the "features, functions, and capabilities" of the actual facilities that the LEC retains. Similarly, the "interconnections" that LECs provide to new entrants are not actual facilities. Rather, interconnection is the act or function of "physical linking of two networks for the mutual exchange of traffic." *Id.* ¶ 176 (JA 276).

Accordingly, even if the word "the" had the significance that the Eighth Circuits ascribes to it, the question under § 251(d)(1) is what are the "costs" of "providing" the "features, functions, and capabilities" that the new entrant has requested from the LEC. That determination inherently requires judgments that are separate and apart from determining the costs of the "actual facilities" of the incumbent. In all events, the Act can scarcely be said unambiguously to bar the use of a replacement cost method to determine the costs of providing interconnection to the "features, functions, and capabilities" of LECs facilities.

In short, even if TELRIC did not determine the cost of providing the "actual facilities" of an incumbent LEC, the rule would rest on a permissible and manifestly reasonable interpretation of § 252(d)(1) to which the Eighth Circuit was required to defer. *Chevron, U.S.A., Inc.* v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984).

C. The Eighth Circuit's Decision Would Require Ratemaking Methods That Either Irrationally Inflate Rates Well Above TELRIC Or Require Rates Far Below TELRIC.

Finally, the Eighth Circuit's decision would require that states set network element rates under methods that either would irrationally inflate rates in ways that have been uniformly condemned or would require rates far less

favorable to LECs than TELRIC. That the Eighth Circuit's decision would require one of two extreme opposing outcomes underscores the reasonableness of the FCC's policy choice.

First, if the FCC did not further modify its regulation on remand, the Eighth Circuit's decision would require states to set interconnection and element rates by attempting to divine the current prices for existing facilities that are approaching obsolescence and that no rational carrier would replicate. In particular, while the Eighth Circuit vacated the subsection of the rule requiring the use of the most efficient available technology, it did not vacate the subsection that prohibits consideration of the historic costs that the incumbent LEC incurred in purchasing the facility and that are recorded in the incumbent LEC's books of account. 47 C.F.R. § 51.505(d)(1). Nor did the Eighth Circuit vacate the subsection that requires the states to calculate the forward-looking cost of the "total quantity of facilities and functions" required to satisfy the current demand for the element. *Id.* § 51.505(b).

Accordingly, as the rule was rewritten by the Eighth Circuit, the only way a state could set rates would be by attempting to establish "up-to-date prices" for the LECs' existing facilities, including their concededly "out-of-date properties." J. Bonbright et al., *Principles of Public Utility Rates* 294 (2d ed. 1988). Indeed, the Eighth Circuit acknowledged the arguments that acceptance of the LECs' claims would require "rates based on the cost of reproducing obsolete technology." Pet. App. 7a.

This is an approach that is "economically meaningless," Bonbright et al., *supra*, at 294, and that has been uniformly condemned. "[T]he 'reproduction cost' to which prices in competitive markets tend to correspond is not the current cost of reproducing the existing plant, brick by brick, but the current cost of producing the *service* with the most modern technology available." 1 A. Kahn, *Economics of Regulation* 112 (2d ed. 1988). As Justice Brandeis explained decades

ago, the efficient replacement cost of the network represents its "maximum value," and the method mandated by the Eighth Circuit's revision to the FCC rule would produce rates that are excessive and would have none of the claimed administrative advantages of a historic cost method in regulating a firm's maximum overall revenues. *Missouri ex rel. Southwestern Bell Tel. Co.* v. *Public Serv. Comm'n*, 262 U.S. 276, 312 (1923) (Brandeis, J., concurring in the judgment). It thus would be patently irrational in the current context of setting the rates for the essential inputs that bottleneck monopolists provide to their retail competitors.

The incumbent LECs cannot and do not defend the use of this method. Instead, they dispute that it is required by the Eighth Circuit's revision of the regulation, and they claim that the Eighth Circuit has simply authorized the setting of rates based on the sum of the historic costs of the LECs' sunk facilities and the incremental costs of modifying them to accommodate new entrants.[26] But the Eighth Circuit squarely and correctly held that such a method is not required by the statutory terms and would be inconsistent with the Act's "stated purpose[]" of promoting competition and efficiency. Pet. App. 10a.

At the other extreme, the Eighth Circuit's decision would permit the FCC – on remand – to adopt methods that are less favorable to incumbent LECs than TELRIC. Indeed, the Eighth Circuit discussed one such approach: short run incremental cost. Under this method, the incumbent LECs would, in the Eighth Circuit's words, recover only costs that the LECs will incur in modifying their networks to allow new entrants to ride "piggyback[]" on the LECs' "existing facilities." Pet. App. 8a. This method would be dramatically less favorable to LECs than TELRIC, for it would allow them

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[26] Brief in Opposition of BellSouth, SBC, and Verizon, at 11; C.A. Docket No. 1308060-1, Opposition of Qwest Corp. to Respondents' Motion for Partial Stay of Mandate, at 3 n.3.

to recover only "the cost to the [incumbent] LEC of providing that ride" and none of the capital costs of the LEC's network. *Id.*

Such a rule would be consistent with the terms of the Act and could have been adopted by the FCC. However, in its order, the FCC instead pursued the reasonable policy objectives of setting network element rates based on economic costs and maintaining the incentives of new entrants to construct alternate facilities whenever that is economically efficient. For the reasons stated above, Congress plainly gave the FCC the choice of pursuing these objectives.

In sum, TELRIC rests on a reasonable interpretation of § 251(d)(1) to which the Eighth Circuit was required to defer. The entire regulation is valid.

II. THE NETWORK ELEMENT COMBINATIONS RULE IS VALID.

The Eighth Circuit also erred in refusing to reinstate the FCC Rules (51.315(c)-(f)) that require the incumbent LECs to combine network elements in certain circumstances. These rules implement the requirements of § 251(c)(3) of the Act, and are valid under this Court's construction of this provision in *AT&T Corp.* v. *Iowa Utilities Board* – as the Ninth Circuit has held. *U S West Communications* v. *MFS Intelenet, Inc.*, 193 F.3d 1112 (9th Cir. 1999).

Section 251(c)(3) requires incumbent LECs to provide requesting telecommunications carriers access to their "network elements" on an "unbundled" basis on rates, terms and conditions that are "just, reasonable, and nondiscriminatory," and "in a manner that allows requesting carriers to combine such elements in order to provide" telecommunications service. 47 U.S.C. § 251(c)(3). Because there are many instances in which competing carriers using network elements need more than just a single element, network elements are commonly ordered in combinations.

FCC Rules 315(b)-(f) address the incumbent LECs' responsibilities to provide combinations of network elements. Rule 315(b) addresses network elements that the LEC "currently combines" for itself, and prohibits the incumbent from providing such elements to competitors in piecemeal or "separate[d]" form, as opposed to combined form (unless the competitor so requests). 47 C.F.R. § 51.315(b). Rule 315(c), in contrast, addresses LECs' responsibilities to perform the functions necessary to create new combinations of their network elements. It provides that, if certain technical requirements are met and the requesting carrier pays the costs, then "an incumbent LEC shall perform the functions necessary to combine unbundled network elements in any manner, even if those elements are not ordinarily combined in the incumbent LECs' network." *Id.* § 51.315(c). Rules 315(d)-(f) deal with other aspects of network element combinations, such as the combination of LEC network elements with competitors' network elements, and the assignment of the burden of proof with regard to various technical showings. *Id.* § 51.315(d)-(f).

In its original *Iowa Utilities Board* decision, the Eighth Circuit invalidated all of these rules. Its holdings were based on its constructions of two portions of § 251(c)(3). First, the Eighth Circuit construed the term "unbundled" in the first sentence of § 251(c)(3) to mean "uncombined," and therefore held that "Section 251(c)(3) requires an incumbent LEC to provide access to the elements of its network only on an unbundled (as opposed to a combined) basis." *Iowa Utils. Bd.* v. *FCC*, 120 F.3d 753, 813 (8th Cir. 1997). Second, it construed the second sentence of § 251(c)(3), which provides that "[a]n incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service," 47 U.S.C. § 251(c)(3). The Eighth Circuit held that its "plain meaning" is that "requesting carriers will combine the unbundled

elements themselves; the Act does not require the incumbent LECs to do *all* of the work." *Iowa Utils. Bd.* v. *FCC*, 120 F.3d at 813.

On review, this Court upheld Rule 315(b), and rejected each of the statutory interpretations on which the Eighth Circuit had relied to strike down all the challenged subparts of Rule 315. First, it held that the term "unbundled" in § 251(c)(3) does not mean "physically separated," but rather means "to give separate prices for equipment and supporting services." *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. at 394.

Second, the Court rejected the Eighth Circuit's interpretation of the "plain meaning" of the second sentence of § 251(c)(3). The Court held that the requirement that the LECs provide network elements in a manner that "allows requesting carriers to combine" them "contemplates that elements *may* be requested and provided" in "discrete pieces," but "does not say, or even remotely imply, that elements *must* be provided only in this fashion and never in combined form." *Id.* This Court held that the combinations requirement of section 251(c)(3) was ambiguous. *Id.* at 395.

Finally, having rejected the grounds for the Eighth Circuit's decision, this Court upheld Rule 315(b) as an "entirely rational" interpretation of the Act, "finding its basis in § 251(c)(3)'s nondiscrimination requirement," which is contained in the first sentence of § 251(c)(3) and which the Eighth Circuit had not discussed. *Id.* As the Court stated, this requirement prohibits incumbent LECs from imposing terms and conditions on the provision of network elements that cause them to incur greater or "wasteful" costs that the incumbents do not themselves incur. *Id.*

Against this background, the Eighth Circuit was plainly wrong in refusing to reinstate Rules 315(c)-(f). Preliminarily, contrary to Eighth Circuit's statement, its prior opinion *did* "employ the same rationale for invalidating subsections (c)-

(f) as [it] did in invalidating subsection (b)." Pet App. 24a.[27] But the decisive fact is that *Iowa Utilities Board* rejected the ground on which the Eighth Circuit previously invalidated subsections (c)-(f) and has now refused to reinstate it: the Eighth Circuit's holding that the "plain meaning" of the second sentence of § 251(c)(3) "indicates that the requesting carriers will combine the unbundled elements themselves" and "does not require the incumbent LECs to do *all* of the work." *Id.* at 25a; *Iowa Utils. Bd.* v. *FCC*, 120 F.3d at 813. As noted, this Court held the phrase to be ambiguous, and under *Chevron* accepted as reasonable the FCC's interpretation that the statutory language "means that incumbents must provide unbundled elements in a way that *enables* requesting carriers to combine them to provide a service," but "does not impose the obligation of physically combining elements exclusively on requesting carriers," Order, ¶ 294 (JA 296). See *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. at 394-95.

Nor was the language in this Court's opinion dictum. If the Court had not rejected the Eighth Circuit's interpretation of the second sentence of § 251(c)(3), the Court could not have upheld Rule 51.315(b)'s requirement that incumbents provide existing combinations of elements in combined form. It is the case, by definition, that the requesting carrier does not combine these elements itself and that the incumbent LEC is here "doing all the work." The Court quite plainly held that § 251(c)(3) requires that the terms of access be just, reasonable, and nondiscriminatory, but that this subsection does not speak to the "division of labor" between incumbents and new entrants.

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[27] Indeed, in the prior opinion, the entire statutory analysis of the combinations requirements was devoted only to subsections (c)-(f). The decision set forth this rationale and then held "[a]ccordingly" that subsection (b) must also fall "because the rule would permit the new entrant access to the incumbent LEC's network elements on a bundled rather than an unbundled basis." *Iowa Utils. Bd.* v. *FCC*, 120 F.3d 753, 813 (8th Cir. 1997).

Finally, in this latter regard, the Eighth Circuit did not – and could not – dispute that Rules 315(c)-(f) are reasonable means of implementing the requirement of the first sentence of § 251(c)(3) that "nondiscriminatory access" be provided on terms that are "just, reasonable, and nondiscriminatory." See *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. at 395. The FCC explained that "in practice it would be impossible for new entrants that lack facilities and information about the incumbent's network to combine unbundled elements from the incumbent's network without the assistance of the incumbent." Order, ¶ 293 (JA 296). The FCC thus reasonably concluded that absent such rules "requesting carriers would be seriously and unfairly inhibited in their ability to use unbundled elements," and refused to impute to Congress the intent to "impos[e] technical obligations on requesting carriers that they might not be able to readily meet." *Id.* There is no reason or basis to question the FCC's determination that requiring technically proficient incumbent LECs to combine their own network elements, with full compensation, was consistent with § 251(c)(3)'s purpose.

The wisdom of the FCC's rules have been borne out in practice. The Eighth Circuit's original decision to invalidate Rules 315(c)-(f) was based on its unsupported assumption that incumbent LECs would "allow entrants access to their networks" in order to perform combinations. *Iowa Utils. Bd.* v. *FCC*, 120 F.3d at 813. As the FCC subsequently found, however, "incumbent LECs have refused to provide access to network elements so that competitors could combine them" except in highly limited circumstances. See *Local Competition*, 15 FCC Rcd. 3696, 3910 (¶ 482) (1999).[28] Rule

[28] Thus, in state arbitrations, for example, Bell Atlantic (now Verizon) has warned against allowing competitors' employees "with wire snips and screwdriver in hand, to work on" its equipment, and BellSouth has termed such access "an unwarranted and illegal intrusion." *See* Joint Brief of Intervenors in Support of FCC at 57-59, *Iowa Utils. Bd.* v. *FCC*, No. 96-3321 (8th Cir. filed Aug. 16, 1999) (citing incumbent LEC submissions).

315(c) thus represents the only practical way for some network element combinations to be obtained at all.

Moreover, incumbents have taken advantage of the Eighth Circuit's holding to foil competition. The FCC wrote Rule 315 as it did, with the various subparts, to cover comprehensively all scenarios in which network elements might be used in combinations. It sought to ensure that, regardless of the particular combination scenario involved, there would be a level playing field between incumbents and competing carriers and that discriminatory and anticompetitive practices in providing combinations would be prohibited. The FCC employed a single set of legal and policy rationales in support of all Rule 315's subparts (Pet. App. 42a-43a), and the Eighth Circuit's initial decision likewise relied on a single analysis to invalidate all the subparts. *Iowa Utils. Bd.* v. *FCC*, 120 F.3d at 813. But the Eighth Circuit has made a wholly artificial distinction between network elements that the incumbent "currently combines," and those that are not "ordinarily combined." That distinction has, predictably, fostered talmudic disputes over whether various types of network element requests are for combinations that are "new" or "old," or for elements that are "commonly" or "not commonly" combined in the LEC's network. Under the Eighth Circuit's holding, the rights of requesting carriers turn on these meaningless differences.

Those disputes often occur, as would be expected, where the competitive stakes are the highest. For example, a substantial number of customers now order second lines into their homes – for family members, for home offices, for Internet access, or for other reasons – and any carrier that cannot efficiently provision additional lines will be under a substantial competitive disadvantage. However, sometimes the second local loop will not be hooked up to either the incumbent's switch or the customer's premises until the customer places an order for the second line. In those circumstances, incumbent LECs have asserted that they have

no duty to "combine" those network elements if the customer orders service from a competing carrier that uses the incumbent's network elements, even though the incumbent routinely combines the very same elements for itself whenever one of its customers places such an order.

The FCC's adoption of rules for new combinations was an "eminently rational" approach to implementing section 251(c)(3) (*AT&T Corp.* v. *Iowa Utilities Board*, 525 U.S. at 395), drawing as it did on the FCC's unique knowledge of the telecommunications industry and judgment regarding the impediments to competition that would otherwise arise. It was not the Eighth Circuit's place to second-guess the agency when Congress did not specifically direct otherwise. This Court should reinstate Rules 315(c)-(f).

CONCLUSION

For the reasons stated, the Eighth Circuit decision should be reversed insofar as it vacated Rules 51.315(c)-(f) and 51.505(b)(1).

Respectfully submitted,

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